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COMMERCIAL PAPER AND THE FEDERAL RESERVE BANKS

The Federal Reserve Board is empowered to formulate rules and regulations for putting into effect many requirements which very wisely are expressed in general terms in the Federal Reserve Act. One of the first and most important duties of the Board will be to determine the character of the paper which the reserve banks may rediscount for member banks. In this particular instance the act is explicit regarding certain requirements, while others are left to the determination of the Board in accordance with general principles laid down in the measure. Rediscounts are restricted to paper maturing within ninety days, aside from a limited amount of agricultural and live-stock paper maturing within six months. Notes, drafts, and bills of exchange may be rediscounted; in other words, form is immaterial, since practically all kinds of negotiable instruments used for borrowing purposes are included. Collateral loans when the collateral consists of stocks or bonds are specifically excluded from rediscount, while commercial paper, whatever its form, is eligible. The act does not define commercial loans except in most general terms, but directs the Federal Reserve Board to do so more precisely.

The provision in the act regarding the general character of the paper which may be rediscounted reads as follows:

Upon the indorsement of any of its member banks, with a waiver of demand, notice, and protest by such bank, any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act.

It may at once be noted that the word "commercial" is given first a broad and later a restricted meaning. When coupled with agricultural and industrial, it evidently means merchandizing or trading; when used alone, it evidently includes not only trading but

also agricultural and industrial operations. Any sale of goods may properly be described as a merchandising or trading transaction from the point of view of the seller. But if the purchaser is engaged in agriculture or in manufacturing, the purchase is not for him a trading operation, strictly speaking, and so, in the restricted sense of the word "commercial," loans made to such persons to enable them to finance purchases would not be commercial loans. Under the broader definition of the term, it is evidently the intent of the law that the paper both of the seller and of the purchaser of goods is eligible for rediscount if the proceeds are to be used in connection with current undertakings. The term "commercial loan" may provisionally be defined, therefore, as any loan which enables a borrower who is engaged in the production or distribution of goods to finance such quick assets as he may require, whether merchandise purchased or goods sold.

Most of the loans made by commercial banks provide the business community with no more funds than are needed for these purposes, but in particular cases there is no certainty that this is the limit of accommodation granted. It is the duty of the Federal Reserve Board to formulate such regulations regarding rediscounts as will make it reasonably certain in practice that the proceeds of rediscounted paper have been used to finance quick assets. In framing its regulations, however, the Board is not bound to confine itself solely to those which would exclude from rediscount paper which is not of a commercial character. Additional restrictions may properly be imposed in order to enhance the safety and liquidity of the paper rediscounted, and also to lessen the danger of the overexpansion of credit. But at the same time care must be taken not to impose restrictions so stringent in character that the banks generally would not in the ordinary course of their business secure eligible paper. The general economic advantage of the community must also be considered. Restrictions should not be imposed which would hamper business enterprise or lead to the concentration of credit in the large cities.

Before making any attempt to apply these various considerations to the determination of the kind of paper which should be rediscounted by the reserve banks, it is necessary to give considera-

tion to the two quite distinct principles upon which in practice credit is granted by banks. Commercial credit may be based either upon specific transactions, the purchase and sale of particular commodities, or upon the character and business condition of the borrower as determined from statements and in other ways. Each of these principles gives rise to two methods of borrowing—the specific transaction to the discount of double-name mercantile bills and notes and to loans on book credits, the general standing of the borrower to single-name paper and to the bank acceptance.

The specific transaction has from time immemorial been regarded as a proper basis for bank credit, while credit has been granted in large volume upon the other principle only within comparatively recent times. Tradition is all in favor of the specific transaction, and at first sight it would seem self-evident that if the maker's own note is good the addition of another signature could hardly fail to make it still better. Analysis, however, will show that single-name paper may be and in practice is distinctly superior in very nearly every respect. This is because the two kinds of paper are the outcome of two quite different methods of conducting business and that method which occasions single-name paper is far more conducive to sound and healthy trade and industrial conditions.

Single-name paper and the bank acceptance have to an increasing extent taken the place of double-name mercantile paper all over the world, except in France where three names are required at the Bank of France. The payment of cash for commodities has brought this change about. In some lines of business because of the marketable nature of the product, and in others because of the strong position of producers, cash payments have been insisted upon. In many other lines of business the obvious advantage of speedy payment has been sufficient to lead to the offer of discounts for cash much above ordinary rates for bank loans. When purchasers pay cash, obviously the double-name mercantile bill or indorsed note cannot come into existence. Purchasers must either have enough capital of their own to make payments or must borrow directly from their banks.

In European countries there is not a little direct borrowing, but

funds are also secured through bank acceptances. The bank acceptance is, however, nothing more than single-name paper indorsed by one bank and discounted by another bank. The general credit situation is not appreciably strengthened by this arrangement. If A draws a bill on bank X, which after acceptance is discounted by bank Y, and the bill of B accepted by Y is discounted by X, there is no greater security for the two loans taken together than would be given if A had borrowed directly from X and B from Y. Inasmuch as banks in this country may not accept bills drawn for domestic purposes, borrowers in this country must be able to secure funds on their own promissory notes if they are to continue to make cash payments.

Business is altogether likely to be kept in a stronger condition when cash payments are the rule than when each producer and dealer owes for what he has bought and is owed for what he has sold. Many, nay most, men are so constituted that in periods of active business and general optimism they will buy far more on credit than they would have bought if required or expected to pay cash. Mercantile credit is far more likely to be extended beyond safe limits than bank credit, partly because the rate of return on sales is greater than that on bank loans, and even more because bankers, comparatively speaking, are a highly conservative class of business men. Where purchasing ability is limited by cash payments, it is to be expected that the danger of a generally overextended condition of business will be somewhat lessened. Even where cash discounts are not taken, dealers selling goods to numerous purchasers scattered over a wide territory would find the handling of mercantile bills and notes far more expensive and troublesome than book accounts and direct borrowing from the banks. Moreover, on account of the various explicit or implied warranties generally customary when goods are sold from samples by traveling salesmen, many bills and notes would not be negotiable instruments and would therefore be unavailable for discounting purposes.

When this problem is considered from the standpoint of the banks, the same conclusion emerges. If credit is based upon specific transactions, there is no means of determining whether the amount

of borrowing on the sales made has been kept within safe limits, having regard both to the character of the purchasers and to the obligation of the borrowers to those from whom they have purchased. Many of the most notable failures in banking history (the Gurney failure for example) have been due to excessive discounts of paper representing actual sales of commodities, because purchasers had overbought and the borrowing sellers were overburdened with obligations on account of what they themselves had purchased.

Borrowing on sales made on a time basis creates contingent liabilities, and notoriously, contingent liabilities are likely to be regarded as no liability at all. Cash payments tend to diminish the contingent obligations of borrowers. They free the banks to a large extent from the necessity of going behind the borrower to the persons to whom he has sold his product. In the early years of the evolution of borrowing on single-name paper it was perhaps less safe than double-name paper. As the practice has become more general, statements from borrowers and credit analyses have become customary and they are proving potent safeguards. Gradually a more exact knowledge of the limits within which credit can be safely granted to particular persons and in different lines of business is being developed. This knowledge can never be developed satisfactorily if the specific transaction is made the basis for credit. Much of course remains to be done in the field of credit analysis. All borrowers do not furnish statements. They are often incomplete or carelessly put together, and sometimes are dishonest fabrications. They are also generally furnished at too infrequent intervals. Here the Federal Reserve Board may render valuable service by setting up requirements regarding single-name paper which will further the efforts of member banks in securing accurate and current information. The Board might well require annual and perhaps semiannual statements from all borrowers whose paper was made eligible for rediscount, and in the case of large borrowers an audit by certified public accountants.

Single-name paper seems at first sight far less liquid than double-name paper arising out of specific transactions. In the ordinary course of business it is presumed that the date of payment

will be sufficiently distant to permit the purchaser to complete the transaction in connection with which the purchase was made. Paper of this character is in a sense self-liquidating. This is, however, also true of single-name paper if it has been confined within proper limits. In each instance a part of the quick assets of the borrower is financed, and in each case if the volume of business is reduced the borrower will be able to liquidate a part of his obligations. But if the volume of his dealings is not lessened, even though particular loans may be liquidated, new loans will have taken their place. This is true whether the borrowing is on double- or on single-name paper.

The view has found expression in some quarters that the over-expansion of credit is impossible if loans are based upon actual transactions. A moment's reflection will disclose the dangerous fallacy in this contention. Suppose that all sales were put upon a time basis and that all the resulting receivables were discounted at the banks; it is certain that an amount of credit vastly greater than that at present granted would be required. Prices of commodities would advance and these advances would furnish the basis for a still greater volume of credit upon the same physical volume of trade. Of course most persons would be too wise to discount all receivables, but if particular transactions are made the primary basis for loans, and credit analysis instead of being strengthened is allowed to lapse, many would take advantage of the situation. The banks would have no adequate check upon excessive borrowing by particular firms.

The universal use of double-name paper would almost certainly prove to be an especially grievous matter for farmers and other small producers. The farmer now receives cash for very nearly all that he sells, but if cotton and grain dealers should be unable to borrow from banks in order to pay cash, the farmer would be obliged to accept notes and bills of exchange for his products. These he might sell to his local banks, but surely the credit of dealers in agricultural commodities can be far more accurately determined by the bankers of the cities who come into direct contact with them.

Any attempt to restore the use of double-name paper would

not only involve revolutionary changes in existing banking arrangements but would also tend toward the concentration of credits in the large cities. Aside from the double-name paper which might be created if farmers were paid in notes, its use would tend to concentrate generally desirable paper in the large distributing centers of the country. The sales by wholesalers to retailers, for example, now give rise to a demand for loans wherever the goods are delivered. Under the double-name arrangement, the paper would appear where the sales offices of producers are situated, chiefly in the large cities.

The only possible ground for excluding single-name paper from rediscounting would seem to be the difficulty of making certain that the proceeds of such loans have in fact been used or are to be used for commercial purposes. Names of two persons engaged in businesses which would naturally make one a purchaser of the product of the other provide fair evidence that the paper is of the right sort. In the case of single-name paper the difficulties are greater but not insuperable—certainly they are not great enough to warrant its exclusion from rediscounting. It will not be difficult for the reserve banks to find out whether the one name is that of a person engaged in business who might therefore be expected to be borrowing for commercial purposes. A copy of the statement of the borrower filed with his own bank would furnish some indication whether or not his borrowings were beyond what might be safely employed in financing his current assets. Further regulations designed for the same purpose might be set up, but a detailed consideration of such regulations does not fall within the limits of the present paper.

Both single- and double-name paper should be eligible for rediscount without differences in rate for similar maturities. Double-name paper will continue in use in those parts of the country in which there is a scarcity of banking credit relative to local demand for its use. It is, however, probable that under the operation of the federal reserve banking system banking funds will flow more readily between different sections of the country. Consequently means will become available for the further extension of the practice of cash payments and the use of single-name paper.

The opinion has been expressed in some quarters that there can be no broad discount market in the United States unless a considerable amount of double-name paper becomes available. This view is based upon a complete misconception of the true nature of a discount market. A broad discount market is one to which many borrowers and lenders regularly resort. We have long had such a market in this country in normal times provided by note brokers. In periods of financial strain, this market has invariably become seriously dislocated on account of the absence of any central rediscounting institutions such as are to be provided through the establishment of the federal reserve banks. In fact, unless single-name paper is discriminated against by the Federal Reserve Board, it is probable that the volume of paper marketed by note brokers will not be less than in the past and may be very much greater. It is even more certain that the ordinary banks will rediscount for each other with greater freedom. A broad and stable discount market will thus be secured. Nothing more could be accomplished through the return to the antiquated practice of double-name trade paper.

Improvement of present practice in the granting of commercial credit rather than revolutionary changes is all that is required under the terms of the Federal Reserve act. Nothing more is needed to provide the reserve banks with paper which will meet every test of safety and which will be of general advantage to the community.

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